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In The

Supreme Court of the United States

OCTOBER TERM, 2000

WAYNE I. ELLIOTT, FRANCIS MARITOTE,
J. BRIAN SCHAER, AND JONATHAN A. SION,
Petitioners,

v.

COMMODITY FUTURES TRADING COMMISSION,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF *AMICUS CURIAE* OF THE BOARD OF TRADE OF THE CITY OF CHICAGO, INC. IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

CAROL A. BURKE
ANNE C. POLASKI
BOARD OF TRADE OF THE CITY OF CHICAGO, INC.
141 W. JACKSON BOULEVARD
6TH FLOOR
CHICAGO, ILLINOIS 60604
(312) 435-3726
Counsel for Amicus Curiae

JOHN H. STASSEN*
KIRKLAND & ELLIS
200 E. RANDOLPH DRIVE
CHICAGO, ILLINOIS 60601
(312) 861-2238
Counsel for Amicus Curiae
**Counsel of Record*

38pp

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(CFTC January 25, 1991) 7

FEDERAL STATUTE

Commodity Exchange Act, 7 U.S.C. §1, *et seq.*.....1

All parties have given their written consent to the filing of this Brief *Amicus Curiae* in support of the Petition for Writ of Certiorari by the Chicago Board of Trade ("CBOT®" or "Exchange").[1]

INTEREST OF THE *AMICUS CURIAE*

The CBOT, a Delaware not-for-profit corporation, has been designated by the Commodity Futures Trading Commission ("Commission" or "CFTC") as a contract market for the trading of various commodity futures contracts, and it is the largest futures exchange in the United States. Its membership includes futures commission merchants, floor brokers, floor traders, commercial users of the commodity futures markets and other entities and persons involved in the futures industry.

The Petitioners are all members of the CBOT. The United States Court of Appeals for the Seventh Circuit affirmed the decision of the Commission which found that each of the Petitioners had engaged in noncompetitive wash sales, and had caused non-*bona fide* prices to be reported, in violation of various provisions of the Commodity Exchange Act ("Act"), 7 U.S.C. §1, *et seq.*, and Commission regulations. The subject transactions all involved calendar spread trades in the CBOT's Wheat futures contract.

The Seventh Circuit applied a deferential standard of review and concluded that the Commission's finding of noncompetitive wash trading was based on reasonable inferences from the circumstantial evidence. Specifically,

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[1] No counsel for a party authored this Brief in whole or in part, and no person or entity, other than the *amicus curiae* made a monetary contribution to the preparation or submission of this Brief.

the Seventh Circuit deferred to the Commission's analysis of the common characteristics of the charged trades, including the symmetrical trading pattern involving spreads in identical quantities at the same price. However, this conclusion is inconsistent with the Seventh Circuit's acknowledgement that "freshening" trades constitute a legitimate trading strategy. As stated in Judge Easterbrook's dissent:

> The CFTC thought the symmetry of the transactions proof of arrangement. But most if not all freshening trades will be symmetrical, if the traders do their jobs right. To complain about symmetry is to complain about freshening in the closing weeks of a contract (when few traders remain) – which is contrary to the premise that freshening is lawful.

(Petition App. B at 38b).

The interest of the CBOT in this matter is the impact that the Seventh Circuit's decision may have on the liquidity and consequent effectiveness of the Exchange's agricultural futures markets as they near expiration. The Exchange is concerned that if the Seventh Circuit's decision is not reversed, it may have the unintended consequence of imposing a *de facto* ban on date freshening, a trading practice which is beneficial to the proper functioning of these expiring futures markets. This Brief *Amicus Curiae* attempts to provide the Court with additional perspective with regard to the importance of preventing the inhibition of legitimate trading activity.

SUMMARY OF THE ARGUMENT

Freshening dates is a legitimate practice that benefits the markets by preserving market liquidity. The Seventh Circuit conceded that freshening is a legitimate trading strategy. Expert testimony submitted to the Commission's Administrative Law Judge concluded that freshening improves liquidity and competitive conditions during expiration periods, which ultimately enhances the accurate discovery of market prices. At the same time, there is a heightened need for liquidity during contract expirations as a result of various factors that tend to decrease liquidity. By adding liquidity, freshening enables the commodity futures markets to more effectively fulfill their valuable economic purposes. Despite its attempt to acknowledge the legality of freshening, the Seventh Circuit's affirmance of the Commission's decision appears to outlaw the practice.

A failure to reverse the Seventh Circuit's decision may effectively prohibit freshening dates. The Seventh Circuit affirmed the Commission's determination that freshening trades that were executed in the same quantities, in close temporal proximity, and at the same prices, were noncompetitive wash sales. Therefore, a line has been drawn that may have the effect of outlawing legitimate economic behavior through a *de facto* ban on freshening. Market participants are likely to interpret the decision to indicate that the practice of freshening has been deemed to be illegal, and may cease trading delivery month contracts.

Moreover, the Seventh Circuit's affirmance of the Commission's decision has created a conflict with the Second Circuit's decision in *Stoller v. Commodity Futures Trading Commission,* 834 F. 2d 262 (2d Cir. 1987)(Petition App. E), which held that freshening trades at a uniform price could not, by themselves, be deemed to be illegal

wash trades without adequate prior notice to the public. The current state of uncertainty could result in traders' unwillingness to freshen their positions, which may adversely affect the liquidity of expiring agricultural futures contracts.

ARGUMENT

I. Freshening Dates Is A Legitimate Practice That Benefits The Markets By Preserving Market Liquidity.

The Seventh Circuit's decision conceded that freshening is a legitimate trading strategy, citing both the testimony of the Commission's expert witness, and a treatise on commodities regulation. (Petition App. B at 3b). In his dissent, Judge Easterbrook also stated that

> [f]reshening adds liquidity to the market near contract expiration, when it is much needed, and enables traders to stay in the market longer, which assists hedgers who want to retain opposite positions.

(Petition App. B at 27b).

In written testimony submitted to the Commission's Administrative Law Judge, Dr. Scott Irwin, then an Associate Professor of Agricultural Economics at The Ohio State University, concluded that:

> The practice [of trade freshening] improves liquidity and competitive conditions during expiration periods. This in turn helps to speed the convergence of futures and cash prices and enhance the accurate discovery of market prices. There is a strong economic argument that the practice of trade freshening plays a positive role

> in the delivery process of agricultural futures contracts.

(*Amicus* App. A at 8a). In its Opinion and Order, the Commission noted that Dr. Irwin

> . . . described the illiquidity of agricultural futures contracts as they approach expiration and gave his opinion that traders who participate during the delivery cycle add a beneficial competitive force by creating liquidity during this period.

(Petition App. C at 8c, n. 8).

Floor traders play a valuable role in the orderly liquidation of agricultural futures contracts and improve the efficiency of the delivery process. (*Amicus* App. A at 6a). In particular, trade freshening adds liquidity to the market, by extending the time in which floor traders can participate during a delivery month, and it likely adds to the efficiency of the market by improving competitive conditions because such floor traders may be willing to take positions for less reward than large commercial participants. (*Amicus* App. A at 7a-8a).

There is a heightened need for liquidity during expiration periods. The risk that a trader may have to take delivery, and pay all associated costs, acts as a disincentive to trade in the delivery period. As recognized by the Commission,

> [m]any traders elect not to hold open positions in the delivery month or are prohibited by their clearing firms from trading during the delivery period because of credit requirements associated with carrying the cash commodity.

(Petition App. C at 4c). Thus the open interest in CBOT agricultural futures contracts becomes concentrated in the hands of fewer market participants during delivery periods, which in turn may decrease liquidity. (*Amicus* App. A at 4a).

In sum, freshening is a legitimate trading practice that adds liquidity to the markets at a time when it is needed, thus enabling those markets to more effectively fulfill their valuable economic purposes. Although the Seventh Circuit has attempted to acknowledge the legality of freshening despite its affirmance of the Commission's Opinion and Order, its decision appears to outlaw the practice.

II. A Failure To Reverse The Seventh Circuit's Decision May Effectively Prohibit Freshening Dates.

As noted by Judge Easterbrook in his dissent, the Commission's decision, which the Seventh Circuit affirmed, inflicts a random penalty on a legitimate trading practice through its determination that the symmetry of the transactions was sufficient proof of prearrangement. (Petition App. B at 37b – 38b). The Seventh Circuit affirmed the Commission's conclusion that freshening trades that were executed in the same quantities, in close temporal proximity, and at the same prices, were noncompetitive wash sales. However, at the same time, the Seventh Circuit admitted that the Commission's Division of Enforcement had not provided any reliable statistics to support its charge that the circumstances of these trades were unusual when compared to freshening trades which had not been prearranged. Indeed, it stands to reason that a freshening trader would have a strong motivation to attempt to execute his freshening trades at

the same prices (if he is unable to make a profit) because, as the Commission noted,

> [i]f the market moves significantly between the liquidation of the original long position and the opening of a new position, the trader may suffer a loss on his or her overall position.

(Petition App. C at 3c).

The Commission previously recognized that a fact-finder must not draw lines that will have the effect of outlawing legitimate economic behavior. *In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,995 (CFTC January 25, 1991). In this case, just such a line has been drawn. Judge Easterbrook noted in his dissent that the Commission's decision, affirmed by the Seventh Circuit, found that symmetrical freshening trades, at a uniform price, violate the Act. (Petition App. B at 28b-29b). The Administrative Law Judge predicted that such a ruling " . . . would function as a *de facto* ban on the freshening of a position by means of a day trade." (emphasis added). (Petition App. D at 13d).

Unless reversed, the Seventh Circuit's decision may effectively prohibit the practice of freshening dates, despite its legitimacy and economic usefulness. Both commercial and non-commercial market participants are likely to interpret the decision to indicate that the practice has been deemed to be unlawful, or at best that its legality is in doubt. Uncertain as to the permissibility of freshening, many traders may simply abandon trading delivery month contracts rather than risk a possible enforcement action. Ultimately, the benefits that the practice confers on the marketplace may be lost.

Almost thirteen years ago, the Second Circuit held, in *Stoller*, that freshening trades at a uniform price could

not, by definition, be deemed to be illegal wash trades, in the absence of adequate prior notice to the public. (Petition App. E at 11e). Failing to give such notice, the Commission brought an enforcement action against the Petitioners who were alleged to have engaged in freshening of dates. In affirming the Commission's decision, the Seventh Circuit created a conflict with *Stoller*. Although both the Commission and the Seventh Circuit generally indicated that it is possible to execute freshening transactions in a lawful manner, their decisions raise the specter that freshening transactions which are executed between the same parties, at the same price, and within a short period of time, will be presumed to have been noncompetitive wash sales. The result is that the market has been left in a state of uncertainty which could result in traders' unwillingness to engage in date freshening, which may adversely affect the liquidity of expiring agricultural futures contracts.

CONCLUSION

For the foregoing reasons, the CBOT respectfully requests that the Court grant the Petition for Writ of Certiorari.

Respectfully submitted,

CAROL A. BURKE
ANNE C. POLASKI
BOARD OF TRADE OF THE
CITY OF CHICAGO, INC.
141 W. JACKSON BOULEVARD
6TH FLOOR
CHICAGO, ILLINOIS 60604
(312) 435-3726
Counsel for Amicus Curiae

JOHN H. STASSEN*
KIRKLAND & ELLIS
200 E. RANDOLPH DRIVE
CHICAGO, ILLINOIS 60601
(312) 861-2238
Counsel for Amicus Curiae
**Counsel of Record*

SEPTEMBER 15, 2000

APPENDIX

UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

WAYNE I. ELLIOTT, FRANCIS MARITOTE, J. BRIAN SCHAER and JONATHON A. SION, Respondents.	CFTC Docket No. 95-1

TESTIMONY OF RESPONDENTS' EXPERT DR. SCOTT IRWIN

Direct Testimony Of Dr. Scott Irwin

Question: Please state your name and current occupation.

My name is Dr. Scott H. Irwin and I am currently employed as an Associate Professor in the Department of Agricultural Economics at The Ohio State University. My educational background is specialized in the field of agricultural economics. I earned the Ph.D. in Agricultural Economics from Purdue University in 1986, the M.S. in Agricultural Economics from Purdue University in 1983, and the B.S. in Agricultural Business from Iowa State University in 1980.

My teaching program focuses on commodity markets, including futures and options markets. Teaching responsibilities include courses on commodity price analysis, data analysis, agricultural finance, and agricultural futures and options markets. The latter course is a comprehensive survey of the economics of agricultural futures and options markets. Topics examined include the development of futures and options markets, types of traders, market liquidity and efficiency, theory of storage, hedging, and options pricing.

My research program focuses on futures and options markets. In particular, I have emphasized three areas: i) commodity funds, ii) market efficiency, and iii) value of information. I have published widely on the subjects mentioned above, including eight book chapters, thirty-one journal articles, and numerous popular publications. The journal articles have been published in highly respected academic journals such as the *Journal of Futures Markets, Journal of Derivatives, Journal of Financial and Quantitative Analysis,* and *American Journal of Agricultural Economics.*

I also have been highly active in professional organizations related to futures markets. I have served as a member of the Editorial Board for the Chicago Board of Trade for the last nine years. Currently, I am Co-Chair of the North Central Region Committee on Applied Commodity Price Analysis, Forecasting and Market Risk Management. I have also served on the Statistics and Standards Committee of the Managed Futures Association. All of these activities are on a volunteer basis.

Finally, I have maintained an active dialogue with the futures and options industry through presentations and consulting projects. I have been invited to make presentations at industry forums in the United States, Japan, Switzerland, and Sweden. I also have worked on futures and options consulting projects for a number of organizations, including the Virginia Retirement System, Mt. Lucas Management Corporation, and Investors Research Corporation.

Question: Dr. Irwin, have you made any study of the liquidity of agricultural futures contracts as they near expiration?

Yes, I have studied the liquidity of agricultural futures contracts as they near expiration. The study consists of two parts. First, I have reviewed the relevant literature in the area. The two most relevant studies are by Peck and Williams[1] and Paul[2]. Second, I am in the process of analyzing

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[1] Peck, Anne E. and Williams, Jeffrey C. "An Evaluation of the Performance of the Chicago Board of Trade Wheat, Corn, and Soybean Futures Contracts During Delivery Periods From 1964-65 Through 1988-89." Report to the National Feed and Grain Association, April 1991.

[2] Paul, Allan B. "Liquidity Bias in Futures Price Spreads." *American Journal of Agricultural Economics* 68 (1968): 313-321.

recent data for agricultural contracts not covered by the previous two studies.

Question: Dr. Irwin, what does your study show concerning the liquidity of agricultural futures contracts as they near expiration?

The first important finding is the high concentration of long and short open interest in CBOT grain futures contracts during delivery periods. Table 1, drawn from Peck and Williams, shows the concentration of traders during delivery periods over 1982-1989.[3] Concentration is measured as the combined position of the four largest long or short traders, and is shown in absolute terms and relative to open interest and deliverable stocks. Averages over 1982-1989 are reported for position day and midway through the delivery period.

The message from this data is that both long and short positions become concentrated during the delivery periods of CBOT grain futures contracts. Of particular importance is the level of concentration relative to deliverable stocks. At the start of the delivery process (position day), long and short concentration is at least 200 percent of deliverable stocks in all three markets. As expected, this situation abates somewhat as the delivery process progresses through the month. However, even midway through the delivery period, concentration on both the long and short side of the market is relatively high.

The implication of the concentration data is that grain futures markets may become increasingly less liquid during delivery periods. This is especially important for the short side of the market, as there is a relative paucity of deliverable stocks for the shorts to draw upon, if needed, as they

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[3] This analysis is currently in the process of being updated.

attempt to liquidate their positions. Further, it is relatively expensive for shorts to increase the supply of stocks in deliverable position.

The most direct evidence of the increasing demand for liquidity is from contract pricing. If lack of liquidity is a factor in markets during delivery periods, this will be manifested either in a consistent narrowing or widening of the spread between the expiring futures contract and the next nearest to delivery contract. In other words, the price of the expiring contract will tend to consistently increase or decrease relative to the price for the next nearest contract.

Table 2, also drawn from Peck and Williams, shows the behavior of price spreads during delivery months over July 1964 - September 1989. The spread between the expiring futures contract and the next nearest to delivery contract is adjusted for interest costs and the expected timing of deliveries. The change in the spread, on a per month basis, is calculated from the first day of the delivery month to the next to the last day of the delivery month. Note that a negative change implies the price spread declines (narrows) and a positive change implies the price spread increases (widens).

The price spreads, on average, show only a minimal tendency to narrow over the first half of the period. In contrast, there is a substantial narrowing, on average, of the delivery price spread during the second half of the period. This suggests that the demand for liquidity during the delivery period increased during the 1980s.

More recent evidence is presented in Figures 1, 2, and 3. Here, the change in adjusted price spreads is presented for delivery periods from December 1989 through March

1995.[4] The figures show that the narrowing of spreads continued unabated in all three markets through mid-1993. There is some evidence that narrowing has been limited in wheat since contract changes were implemented in July 1993. However, there is not enough data to make a firm conclusion. There is no clear trend in corn and soybeans since contract changes in 1993.

In sum, the available evidence suggests that CBOT wheat, corn, and soybean contracts may become increasingly less liquid during delivery periods. Large shorts have positions that are multiples of deliverable supplies going into the delivery period. This situation can affect contract pricing, because there is a consistent narrowing of the price spread between expiring contracts and next nearest contracts.

Question: Dr. Irwin, have you made any study concerning the role of the local floor trader in agricultural futures contracts as expiration nears?

Yes, I have studied the role of local floor traders during expiration periods. In the economic environment described above, locals have a valuable role in improving the efficiency of the delivery process. Specifically, they provide liquidity to the market when there is a high premium on liquidity services. In this sense, local floor traders play a valuable role in the orderly liquidation of agricultural futures contracts.

Question: Dr. Irwin, have you made any study of locals in the agricultural contracts at the Chicago Board of Trade regarding their ability to provide this liquidity if they have positions which have been outstanding for some period of time?

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[4] The unadjusted spread data are in the process of being adjusted to the same basis as in Peck and Williams' study.

Yes, I have examined the ability of locals to provide this liquidity if they have outstanding positions for some period of time. Delivery rules at the CBOT state that shorts determine the timing of delivery. The way this rule is implemented is important. Specifically, after a short has reported an intention to deliver, the clearing house matches the short with the oldest outstanding long position. If a local has had an outstanding long position for an extended period of time, there is a high probability that his position will be delivered upon. When this occurs, the local is out of the market and he may have limited incentive to return.

Question: Dr. Irwin, are you aware of a practice at the Chicago Board of Trade which locals utilize called "freshening their position" or "getting behind the [delivery] line"?

Yes, I am familiar with the practice of trade freshening. This is a practice typically carried out by a local trader, whereby a local establishes a spread position and instructs his clearing firm to manually match trades so that the "trade date" of his position is updated. In this way, he will remain eligible to trade the contract for a longer period of time unmatched for delivery.

Question: Dr. Irwin, do you have any conclusion as an economist regarding the effect of locals freshening positions upon the liquidity of the market for all users, be they commercial users, funds or speculators?

In the economic environment described above, the practice of trade freshening is beneficial because it extends the time in which local traders can participate in the expiration process. First, trade freshening adds liquidity to the market when there is an exceptionally high premium on liquidity services. Second, there is a more subtle way in which trade

freshening likely adds to the efficiency of the market during delivery periods. Local traders, naturally, will take either outright long positions in the expiring contract or take a long spread position (long expiring, short next nearest). This trading will likely improve competitive conditions in the market, because locals may be willing to take positions for less reward than large commercials. The sum of these two effects of trade freshening is that the narrowing of spreads is smaller than what would otherwise occur.

Question: Dr. Irwin, do you consider the practice of freshening positions (assuming such trades are done otherwise in conformity with rules, regulations and customs and practices of the market place) to serve a legitimate economic purpose in the market place?

Yes, I consider the practice of freshening positions (within the rules of the marketplace) to serve a legitimate economic function. The practice improves liquidity and competitive conditions during expiration periods. This in turn helps to speed the convergence of futures and cash prices and enhance the accurate discovery of market prices. There is a strong economic argument that the practice of trade freshening plays a positive role in the delivery process of agricultural futures contracts.

Question: Dr. Irwin, what in your opinion is the effect of not permitting "freshening of positions" in an agricultural contract with relatively few local traders?

The practice of trade freshening is especially valuable in smaller markets, such as the agricultural futures contracts. In these markets, the population of local traders that take positions during the delivery period may be quite low, perhaps as few as four or five traders. Without the ability to

freshen trades, there may not be any locals participating in the market during the delivery period. An important source of liquidity may be lost as a result.

Table 1. Average Concentration of the Four Largest Long and Short Positions in Wheat, Corn, and Soybean Futures Contracts, 1982 -1989.

	Wheat	*Corn*	*Soybeans*
Four Largest Longs on Position Day			
Aggregate Position (mil. bu.)	13.1	37.5	16.8
Percent of Open Interest	39	34	30
Percent of Deliverable Stocks	377	446	224
Four Largest Shorts on Position Day			
Aggregate Position (mil. bu.)	12.1	26.5	19.5
Percent of Open Interest	36	25	33
Percent of Deliverable Stocks	319	237	235
Four Largest Longs Midway Through Delivery Period			
Aggregate Position (mil. bu.)	3.2	11.2	5.5

Percent of Open Interest	59	62	57
Percent of Deliverable Stocks	132	131	90
Four Largest Shorts Midway Through Delivery Period			
Aggregate Position (mil. bu.)	1.7	5.4	3.2
Percent of Open Interest	27	31	32
Percent of Deliverable Stocks	93	67	54

Source: Peck, Anne E. and Williams, Jeffrey C. "An Evaluation of the Performance of the Chicago Board of Trade Wheat, Corn, and Soybean Futures Contracts During Delivery Periods from 1964-65 Through 1988-89." Report to the National Feed and Grain Association, April 1991.

Table 2. Changes in Price Spreads in Wheat, Corn, and Soybean Futures Contracts from the First to the End of Delivery, July 1964 - September 1989.

	Average Change	*Largest Decline*	*Largest Increase*
	(cents per bushel per month)		
Wheat			
July 1964 - May 1979	-0.03	-5.91	9.28
July 1979 - Sept. 1989	-1.52	-21.81	4.27
Corn			
Dec. 1964 - Sept. 1979	-0.79	-4.99	4.01
Dec. 1979 - Sept. 1989	-1.66	-10.35	3.26
Soybeans			
Nov. 1964 - Sept. 1979	-0.01	-9.16	17.54
Nov. 1979 - Sept. 1989	-3.29	-19.09	8.16

Source: Peck, Anne E. and Williams, Jeffrey C. "An Evaluation of the Performance of the Chicago Board of Trade Wheat, Corn, and Soybean Futures Contracts During Delivery Periods from 1964-65 Through 1988-89." Report to the National Feed and Grain Association, April 1991.

Figure 1. Changes in Price Spreads in Wheat from the First to the End of Delivery, December 1989 - March 1995.

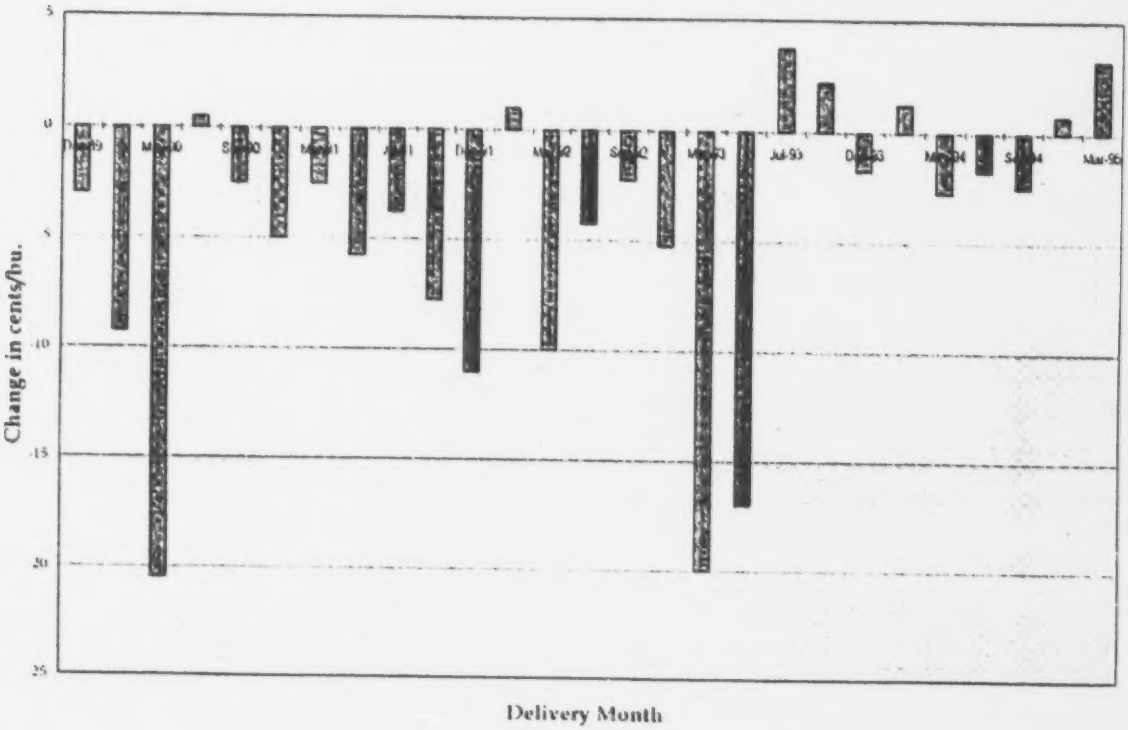


Figure 2. Changes in Price Spreads in Corn from the First to the End of the Delivery, December 1989 - March 1995

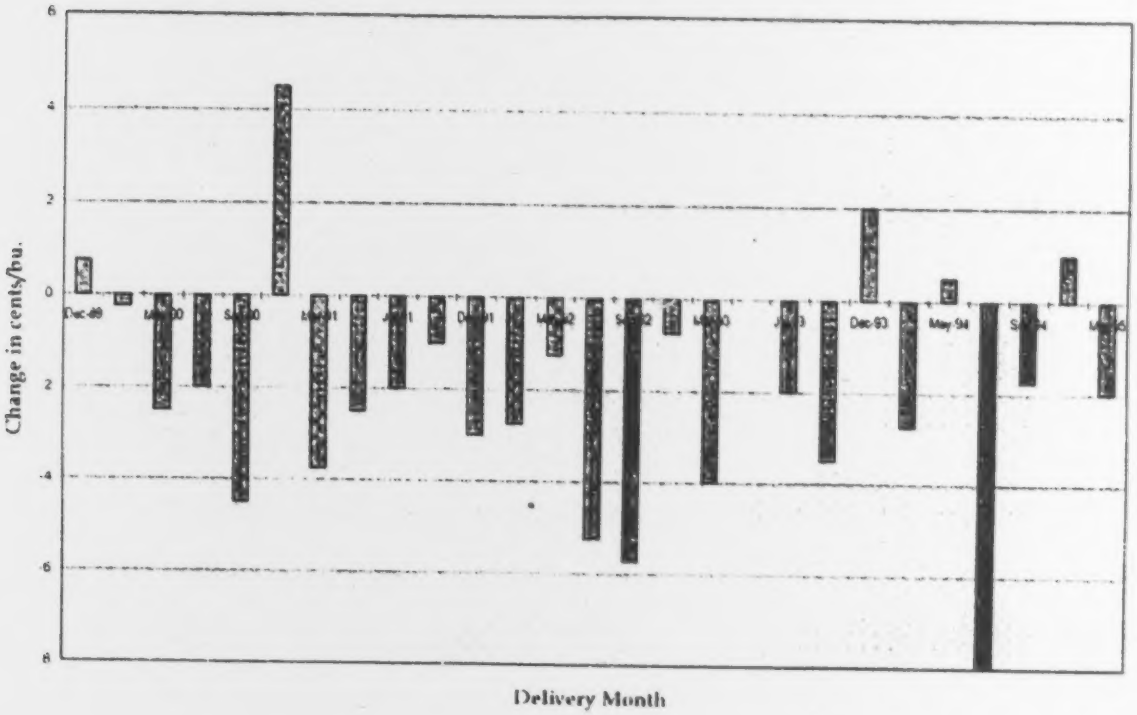
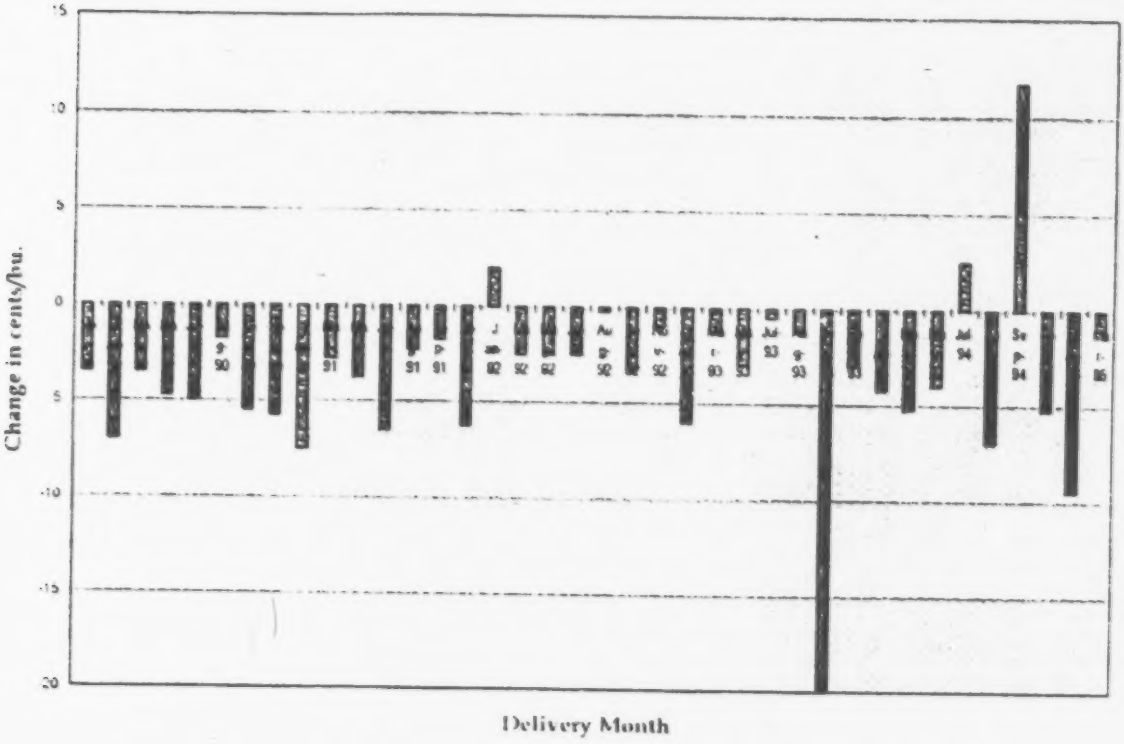


Figure 3. Changes in Price Spreads in Soybeans from the First to the End of Delivery, December 1989 - March 1995.



SCOTT H. IRWIN

Curriculum Vitae

June 1995

ADDRESS:

322 Agricultural Administration Building
2120 Fyffe Road
Department of Agricultural Economics
The Ohio State University
Columbus, OH 43210-1099

Voice: (614) 292-6399
Fax. (614) 292-0078
Email: sirwin@magnus.acs.ohio-state.edu

EDUCATION:

Doctor of Philosophy, Purdue University, 1986

Master of Science, Purdue University, 1983

Bachelor of Science, With Distinction, Iowa State University, 1980

PROFESSIONAL EXPERIENCE:

Associate Professor, The Ohio State University, Department of Agricultural Economics and Rural Sociology, July 1989 to the present

Visiting Scholar, Office for Futures and Option Research and Department of Agricultural Economics, University of Illinois at Urbana-Champaign, July 1993 to July 1994

Assistant Professor, The Ohio State University, Department of Agricultural Economics and Rural Sociology, August 1985 to June 1989

Graduate Research and Teaching Assistant, Purdue University, Department of Agricultural Economics, August 1980 to July 1985

PROFESSIONAL MEMBERSHIPS:

American Economic Association
American Finance Association
American Agricultural Economics Association
Western Agricultural Economics Association
Southern Agricultural Economics Association

AWARDS AND HONORS:

Who's Who in American Education, 1993
Who's Who in the Midwest, 1992
Men of Achievement, 1992
Distinguished Research Award, Ohio Agricultural Research and Development Center, 1988
Resources for the Future Dissertation Fellowship, 1984-1985
Outstanding Master's Thesis in Agricultural Economics, Purdue University, 1983
William G. Murray Award, Outstanding Senior in Agricultural Business, Iowa State University, 1980
Phi Kappa Phi Academic Honorary Society, 1980
Gamma Sigma Delta Academic Honorary Society, 1980
Alpha Zeta Academic Honorary Society, 1977

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